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No. 92-1074

IN THE

Supreme Court of the United States

OCTOBER TERM, 1992

JOHN HANCOCK MUTUAL LIFE INSURANCE COMPANY,
Petitioner,
v.

HARRIS TRUST AND SAVINGS BANK,
as Trustee of the Sperry Master Retirement Trust No. 2,
Respondent.

**On Writ of Certiorari to the
United States Court of Appeals
for the Second Circuit**

**BRIEF AMICUS CURIAE FOR
LIFE INSURANCE COUNCIL OF NEW YORK
SUPPORTING PETITIONER**

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STATEMENT OF INTEREST

The Life Insurance Council of New York, Inc. ("LICONY") represents 63 life insurance companies located in the state of New York.[1] LICONY addresses areas of concern to the New York life insurance industry before legislative and judicial bodies. One area of particular concern is the treatment under the Employee Retirement Income Security Act of 1974 ("ERISA"), 29 U.S.C. §§ 1001-1461, of general account contracts issued by life insurance companies to fund pension plans.[2]

[1] Counsel for Petitioner and Respondent have consented to LICONY's filing in letters filed herewith.

[2] An insurance company's general account is its operating account, whose assets are used to pay the insurance company's op-

Assets invested by private pension plans as of 1991 exceeded \$2.4 trillion. American Council of Life Ins., *1992 Life Insurance Fact Book* 56 (1992). Approximately 31 percent of that amount—about \$746 billion—was held by life insurance companies. *Id.* Over 45 percent of the assets and reserves held by life insurance companies for private pension plans in 1991 were held under group annuity general account contracts. *Id.* at 58.

Under *Harris Trust & Savs. Bank v. John Hancock Mut. Life Ins. Co.*, 970 F.2d 1138 (2d Cir. 1992) [hereinafter "*Harris Trust*"], issuance of such a group annuity general account contract to a pension plan subjected the insurance company's general account to ERISA's fiduciary standards. This decision is contrary to the language of ERISA and the consistent administrative interpretations of the statute since its enactment nearly 20 years ago. The effect of the decision, if allowed to stand, will be to subject the general accounts of life insurance companies—that is, all of the operating assets of life insurance companies—to inherently inconsistent and irreconcilable systems of state and federal regulation.

LICONY's members are regulated under New York law, the same law that applies to the contract at issue in this case. The membership of LICONY includes many of the largest issuers of pension funding contracts and therefore represents many of the companies that stand to be most affected by the outcome of this case. From this perspective, LICONY offers to the Court its legal arguments for reversing that portion of the holding in *Harris Trust* that would subject insurance company general account assets to coverage under ERISA.

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erating expenses, such as salaries and rent, as well as liabilities under contracts issued by the insurance company—so called "general account" contracts. Insurance companies also issue contracts supported by assets held separately from the general account—so called "separate account" contracts.

SUMMARY OF ARGUMENT

At issue in this case is whether insurance company general account assets will be subject to the fiduciary standards of ERISA whenever an insurance company issues a general account contract to a pension plan covered by ERISA.

The business of insurance is risk management—that is, pooling large numbers of risks and satisfying liabilities resulting from those risks from a common fund. New York and every other state already regulate the business of insurance to require that insurance companies have sufficient assets to cover the risks they insure. This state regulation is premised on the fact that each insurance company general account holds assets that may be used to satisfy the liabilities of the insurer on a nonsegregated basis.

In contrast, ERISA requires a plan fiduciary to manage a segregated pool of plan assets solely for the benefit of the participants in one plan. State insurance regulation and ERISA fiduciary rules are thus inheretly incompatible. In many instances, moreover, compliance with state insurance rules would require an insurance company to violate ERISA's fiduciary rules, and vice versa.

The *Harris Trust* decision failed to take into account the practical difficulties raised by dual regulation under state insurance law and ERISA, and the lack of any evidence in ERISA and its legislative history that Congress intended to alter the operation of the entire insurance industry by subjecting it to a system of federal regulation that inevitably conflicts with the industry's explicit obligations under state law.

The Second Circuit held that contracts of the type issued by the Petitioner are not covered completely by ERISA's provision for guaranteed benefit policies. LICONY disagrees with that holding. In LICONY's view, section 401(b)(2) of ERISA serves as a safe har-

bor for contracts of the type at issue here. But even if the Court interprets this provision differently, a general account contract is exempt from treatment as plan assets under the legal principles embodied in the Department of Labor's regulation defining the term "plan assets" for purposes of ERISA's fiduciary rules.

The plan assets regulation provides that a plan investment that establishes a debtor/creditor relationship does not constitute an investment in the underlying assets of the company issuing the investment. Further, even a plan's equity investment in a company does not make the company's assets plan assets as long as the company is an "operating company," that is, a company that does not exist solely as a surrogate for the delegation of plan asset investment authority. General account contracts meet both of these requirements: they establish a debtor/creditor relationship under state law, and they constitute investments in insurance companies, which meet the definition of operating companies.

Because insurance company general account contracts are either explicitly exempt from plan assets treatment under ERISA, or under the Department of Labor's plan assets regulation, or both, that portion of the *Harris Trust* decision that requires their treatment as plan assets should be overturned.

I. THE BUSINESS AND REGULATION OF INSURANCE

The effect of the Second Circuit's decision extends far beyond the contract at issue in this case. To understand the far-reaching results of this decision and why that result is contrary to ERISA, it is necessary to consider the business and regulation of insurance companies and the contracts that they issue.

A. Life Insurance Companies Are Engaged In The Management Of Risk, And Hold All Assets In A Collective Fashion To Satisfy The Company's Obligations.

The principal business of insurance companies is the management of various types of risk. A person or entity purchasing a contract from an insurance company does so to transfer some or all of the risk insured against to the insurer. J. L. Athearn, S. T. Pritchett, J. T. Schmit, *Risk and Insurance* 50 (6th ed. 1989); C. A Williams, Jr. & R.M. Heins, *Risk Management and Insurance* 246 (6th ed. 1989).

An insurance company accepts risks in return for premiums, and then manages those risks through a variety of techniques, including spreading risks over a large number of similarly situated insureds and accumulating a fund to ensure the company's ability to pay in the event that a risk is realized. Athearn at 50; Williams & Hein at 246; R. I. Mehr, *Fundamentals of Insurance* 37-38 (2d ed. 1986).

To provide these risk management services, insurance companies engage in a variety of business-related activities, and they perform all of the functions typical of operating businesses. The company hires employees, pays taxes, owns or leases office buildings, purchases office equipment and furniture, and pays dividends to its owners.

All of these activities are carried out through the insurance company's general account. The general account is not a pooled investment fund held for the benefit of policyholders. Rather, it consists of all of the assets held by the insurance company in the operation of its general business of risk management. Premiums, fees, and other payments for life, health, and annuity products, and for related services, are placed in the general account, invested, and used by the company to pay operating expenses, policy claims, and returns to owners. These assets are not segregated by policyholder or by line of business. Instead, all assets in the general account are avail-

able to satisfy all of the obligations of the general account. K. Huggins, *Operations of Life and Health Insurance Companies* 301 (1986).

B. General Account Contracts Used For Pension Plan Funding Were Developed To Meet The Demands of Pension Plans By Providing Participation In The General Account.

The majority of general account insurance contracts issued by U.S. life insurance companies are "participating." In participating contracts, the contractholder participates in the company's experience, that is, the general account's experience. By sharing a portion of the company's risks, the participating contractholder expects more favorable results.

When group annuity contracts were first developed, most of the insurance business in the United States was written by mutual life insurance companies. Indeed, when Congress was considering pension reform legislation in 1973, mutual companies held two-thirds of all assets held by U.S. life insurance companies. Institute of Life Ins., *Life Insurance Fact Book 1974*, at 89 (1974). Mutual company group pension products, like most insurance products issued by mutual companies, almost always participated in the experience of the general account. K. Black, Jr. & H. D. Skipper, Jr., *Life Insurance* 503 (11th ed. 1987). Stock insurance companies also issue group pension products that typically include a participation feature. *Id.* It is therefore common for all group pension contracts to participate in the experience of the general account.

At the time Congress was considering the pension reform proposals that led to the passage of ERISA, there were three major types of group pension contracts—group deferred annuities, deposit administration contracts, and immediate participation guarantee contracts. The types and levels of guarantees in these different

types of contracts varied. However, all three provided for the ultimate payment of guaranteed benefits to plan participants. It was against this background of established practice that Congress enacted the provisions of ERISA at issue in this case.

C. Both At The Time of ERISA's Enactment And Today, New York, As Well As The Other States, Regulate The Business of Insurance.

All of the states have laws regulating the operations and activities of insurance companies. Black & Skipper at 503. Because most major insurance companies that issue pension funding contracts are regulated by New York insurance law, which also governs the policy at issue in this case, we focus our analysis on New York law. The insurance laws of the other states have similar objectives and use similar approaches to achieve those objectives.

1. New York state insurance law is designed in the first instance to ensure insurance company solvency.

The financial activities and condition of life insurance companies are subject to comprehensive regulation under New York law and the regulations issued by the Superintendent of Insurance, who is responsible for the administration and enforcement of the state's insurance law. N.Y. Ins. Law §§ 201, 301 (McKinney 1985). The primary purpose of this regulatory scheme is to ensure the solvency of companies and their ability to pay all policy claims when due. *The Life Insurance Law of New York* 32-33 (1989).

New York's stringent statutory accounting rules are oriented conservatively toward the maintenance of company solvency. For example, only "'admitted" generally, investment) assets may be counted in determining solvency. Similarly, detailed rules are provided for valu-

ing different classes of assets, and contingency or valuation reserves are established to smooth fluctuations in the value of assets. *Id.* at 33.

In the same vein, the rules for valuing liabilities require use of separate minimum interest rates and prescribed mortality or morbidity tables and reserve valuation methods for each of many separate liability classifications. *Id.* at 34.

New York law also provides detailed rules relating to the investment of general account assets. Generally, the rules are intended to ensure diversification of assets, prudent investment practices, and matching of asset and liability durations. Under N.Y. Ins. Law section 1405(a) (McKinney Supp. 1993), an insurance company may invest no more than 2 percent of its admitted assets in any one company, no more than 10 percent of its admitted assets in foreign securities, and no more than 20 percent of its admitted assets in the aggregate in equity investments. Similarly, no more than 40 percent of general account assets may be invested in certain types of real property, personal property, and other equity investments.

All of these rules are aimed at the maintenance of the company's solvency to protect all of the company's policy holders, without distinction among the different types of policies issued or the nature of the different kinds of policyholders. Thus, a life insurance company's financial statement does not show assets and liabilities separately for each customer, policy type, or class of business. Instead, liabilities and assets are stated in the aggregate, recognizing that claims against the company, regardless of their source, are claims against the general account. Huggins at 301. Similarly, there are no separate funds for reserves and capital; reserves are simply accounting liabilities of the company, and capital and surplus of the

company are the excess of total admitted assets over total liabilities.

The same aggregate approach is true for the investment limitations, which are designed to impose diversification requirements for the entire general account, rather than any particular policyholder or line of business. For example, the 2% limitation on investing admitted assets in a single company applies to the general account as a whole, not assets derived from a particular policyholder or line of business.

New York insurance regulation aimed at protecting company solvency likewise does not distinguish among the different attributes of a company's policyholders. For example, most of the company's liability for its pension business is reflected in its annuity reserves. The annuity lines include policies issued to pension plans subject to ERISA, pension plans not covered by ERISA (such as governmental plans), and individual contracts not related to any overall plan. No distinction is made in computing liabilities between ERISA contracts and other contracts, and there is no segregation of assets in the general account for any of these different classes of policyholders.

2. *New York insurance law regulates insurance company dealings with the public.*

New York state insurance law also establishes strict standards governing insurance company dealings with the insuring public. No insurer may sell a policy unless the form of the policy is approved by the Superintendent of Insurance. N.Y. Ins. Law § 3201(b)(1) (McKinney Supp. 1993). The Superintendent may disapprove any group annuity contract if its provisions are "unjust, unfair or inequitable." *Id.* § 3201(c)(2) (McKinney 1985).

This emphasis on fairness is continued in the state's review of the operation of insurance contracts. No insurance company doing business in the state may

(1) make or permit any unfair discrimination between individuals of the same class and of equal expectation of life, in the amount or payment or return of premiums, or rates charged for policies of life insurance or annuity contracts, or in the dividends or other benefits payable thereon, or in any of the terms and conditions thereof . . . .

N.Y. Ins. Law § 4224(a)(1) (McKinney 1985). This provision does not make the insurance company a fiduciary with respect to any particular holder of a general account contract. *Rochester Radiology Assocs., P.C. v. Aetna Life Ins. Co.,* 616 F. Supp. 985, 988 (W.D.N.Y. 1985). On the contrary, the provision emphasizes that an insurance company cannot under state law provide preferential treatment to any contractholder in the same class.

State law regulating the allocation of income and expenses within the general account further prohibits an insurance company from preferring any single contractholder or class of contractholders. Section 4239 requires the "equitable allocation of income and expenses as among lines of business," N.Y. Ins. Law § 4239 (McKinney 1985), and the Superintendent has issued regultaions approving "only such methods of allocation as will produce a suitable and *equitable* distribution of income and expenses . . . ." N.Y. Comp. Codes R. & Regs. tit. 11, § 92.4(a)(1) (emphasis added).[3] The Superintendent must also review and approve the implementation of methods for allocating investment results to pension contracts, including any amendments to a previously approved allocation method. *Id.* § 91.5(b).

[3] The requirement of fair allocation applies even though some insurance companies attribute certain assets to liabilities solely for income accounting purposes. This bookkeeping practice called "segmentation" does not result in the allocation of assets within the general account, and does not in any way result in the identification of specific general account assets with any specific obligations of the insurer. All general account assets, therefore, continue to support all of the company's general account obligations.

3. *New York insurance law also prescribes the rights of creditors and policyholders in the event of insurance company insolvency or impairment.*

The prohibition against discrimination extends to the liquidation of an insolvent insurer. While New York law establishes eight categories for the distribution of the assets of an insolvent insurer among the company's creditors, no subclasses within each class are permitted. N.Y. Ins. Law § 7435(a) (McKinney Supp. 1993). Under section 7435, claims under life insurance and annuity contracts are treated as a single class, and therefore discrimination with respect to distribution of assets among such contracts is specifically prohibited. *Id.* Moreover, the state does not permit preferential treatment among different categories of contractholders based on whether they are subject to, or exempt from, ERISA requirements.

II. CONGRESS DID NOT INTEND TO SUBJECT INSURANCE COMPANY GENERAL ACCOUNT ASSETS TO FEDERAL REGULATION, AND INDEED SPECIFICALLY RESERVED SUCH REGULATION TO STATE LAW.

An insurance company general account is required by state law to function in a manner designed to protect all policyholders from company insolvency or the prospect of discriminatory treatment. The court of appeals' decision would have the unwarranted and ultimately unworkable effect of superimposing on general accounts a conflicting system of federal regulation designed to hold plan fiduciaries to a standard of unswerving loyalty to the particular interests of the discrete population of the plan which the fiduciary serves.

This result cannot withstand scrutiny. As a matter of national policy, Congress has refrained from imposing federal regulation upon the business of insurance, and has instead reserved that function exclusively to the states. Nothing in ERISA evidences any congressional purpose to depart from that assignment of exclusive responsibility

by indirectly subjecting general account assets to federal regulation through ERISA's fiduciary standards. As a purely practical matter, insurance companies would in any event be unable to comply with the directly conflicting standards of state insurance law and ERISA.

A. The Second Circuit's Decision Contravenes Congressional Intent Manifested In ERISA's Insurance Savings Clause And The McCarran-Ferguson Act To Leave Regulation Of Insurance Solely To The States.

This Court has consistently recognized that federal law supersedes traditional areas of state authority, such as the regulation of insurance, only if this is "the clear and manifest purpose of Congress." *Jones v. Rath Packing Co.*, 430 U.S. 519, 525 (1977) (quoting *Rice v. Santa Fe Elevator Corp.*, 331 U.S. 218, 230 (1947)); *accord FMC Corp. v. Holliday,* 498 U.S. 52, 62 (1990). This precept assures that the essential balance between federal and state regulation is not disturbed. *Jones v. Rath Packing Co.*, 430 U.S. at 525. Congress has explicitly recognized in both ERISA and the McCarran-Ferguson Act that the regulation of insurance should be left to the states.

Section 514(a) of ERISA provides that ERISA ". . . shall supersede any and all State laws insofar as they may now or hereafter relate to any employee benefit plan . . . ." 29 U.S.C. § 1144(a). Notwithstanding this broad preemption of state law to ensure a single, uniform system of federal regulation of employee benefit plans, Congress saved from preemption "any law of any State which regulates insurance. . . ." ERISA § 514(b)(2)(A), 29 U.S.C. § 1144(b)(2)(A). ERISA's Insurance Savings Clause applies to any state law that controls the terms of insurance contracts, *FMC Corp. v. Holliday,* 498 U.S. at 62 (state subrogation laws); *Metropolitan Life Ins. Co. v. Massachusetts,* 471 U.S. 724, 740-41 (1985) (state mandated benefit laws), as well as those aimed directly

at the insurance industry. *FMC Corp. v. Holliday,* 498 U.S. at 62; *Pilot Life Ins. Co. v. Dedeaux,* 481 U.S. 41, 50 (1987).

ERISA's Insurance Savings Clause is a specific application of the congressional policy to leave insurance regulation to the states More broadly, in the McCarran-Ferguson Act, 15 U.S.C. §§ 1011-1015, Congress provided that the "business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation and taxation of such business." 15 U.S.C. § 1012(a). Laws governing the "business of insurance" as that term is applied under the McCarran-Ferguson Act include, among others, laws regulating the internal operations of insurance companies and laws regulating the substantive content of insurance contracts. *FMC Corp. v. Holliday*, 498 U.S. at 62.

There can be no doubt that the provisions of New York insurance law discussed in Section I.C, *supra,* fall within the protection of both ERISA's Insurance Savings Clause and the McCarran-Ferguson Act. These statutes are aimed directly at and apply exclusively to the insurance industry. They regulate the internal operations of insurance company general accounts, and establish standards for insurance companies' contracts with their customers. Congress has therefore expressly excepted these laws from interference by federal regulation.

Notwithstanding these statutes, the court of appeals concluded that whenever a company issues an annuity policy with a participation feature to an ERISA plan, at least some of the assets of the company's general account become plan assets subject to ERISA. This conclusion leads to one of two possible results, each equally untenable.

One possibility is that without any examination of the subject, Congress chose to replace the entirety of state regulation of the business of insurance with the trust law fiduciary principles embodied in ERISA. This possibility is plainly at odds with the express mandates of the in-

surance Savings Clause and the McCarran-Ferguson Act. Moreover, it is entirely unreasonable to infer that Congress intentionally but silently brought about such a sweeping change in the regulation of an entire industry, or did so through sheer inadvertence.

The other possibility is that the simultaneous regulation of insurance company general accounts under ERISA would not materially invade the established sphere of exclusive state regulation. However, as we show below, state regulations governing the management of the general account and the standards imposed by ERISA on plan fiduciaries establish a variety of incompatible rules of conduct, such that no company can faithfully comply with the essential elements of one system without violating explicit rules of the other system.

B. Carrying On The Business of Insurance Would Be Impossible If Insurance Companies Were Required To Comply With The Conflicting Standards of ERISA And State Insurance Law.

The essence of an insurance company's general account and the fundamental assumption of state insurance regulation is that assets in the general account are not segregated for the satisfaction of any particular contract claim. Instead, for purposes of regulating company solvency and company dealings with policyholders, state law requires that general account assets be maintained as the corpus from which every policyholder, employee, creditor, and owner may expect the company to perform its undertakings. All of the state rules governing the accounting for the company's assets and liabilities and the investment of general account assets flow from this premise. *See* Section I, *supra*.

ERISA, in contrast, requires that the management of plan assets be conducted by a fiduciary whose overriding duty is to conduct all of his functions "solely in the interest of the participants and beneficiaries" of the plan, ERISA § 404(a)(1), 29 U.S.C. § 1104(a)(1), and for

the "exclusive purpose of" paying the benefits promised by the plan and defraying the plan's administrative expenses. ERISA § 404(a)(1)(A), 29 U.S.C. § 1104(a)(1)(A). This duty of undivided loyalty is the essential quality of an ERISA fiduciary and it is the foundation of ERISA's system of fiduciary regulation. *NLRB v. Amax Coal Co.*, 453 U.S. 332, 334 (1981). Inherent in this system is the principle that "plan assets" are held separately and are available only for the purpose of paying benefits and expenses of the plan to which the assets belong. This principle precludes, for example, a loan from a pension plan to a health plan with the same trustees and many, but not all of the same participants. *Cutaiar v. Marshall*, 590 F.2d 523, 529-30 (3d Cir. 1979).

The Second Circuit's decision assumes, without any examination, that general account assets that are in some fashion attributable to the participating features in an annuity contract may be segregated as assets of the particular plan which holds the contract, and that these segregated assets may be subjected to the full array of ERISA's fiduciary rules without affecting the treatment of the general account as a whole. The type of segregation implied by the Second Circuit cannot occur as a practical or as a legal matter.[4]

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[4] New York law already provides for the issuance of contracts supported by assets segregated in a separate account. N.Y. Ins. Law § 4240 (McKinney 1985 & Supp. 1993). These assets are not chargeable with the general liabilities of the insurance company, *id.* §§ 4240(a)(12) (McKinney 1985), 7435(b) (McKinney Supp. 1993), and are subject to a vastly different level of regulation under state law.

In 1973, when Congress was deliberating over pension reform legislation, life insurance company reserves for pension plans totaled $56.1 billion, of which only $9.6 billion—about 17%—was attributable to separate account contracts. Institute of Life Ins., *Life Insurance Fact Book 1974*, at 36. Congress was aware of the provisions of state law allowing insurance companies to offer investments in separate account contracts, and included a provision in ERISA providing that, with specified exceptions, the assets invested by a plan in a separate account contract constitute plan assets,

State law does not permit the segregation of assets within the general account for the exclusive satisfaction of the obligations of a particular contract. Thus, under the Second Circuit's rationale, a company that issues a participating annunity contract that encompasses plan assets must deal with those plan assets separate from its other general account assets and apply them to the exclusive purposes of the plan that holds the contract, in violation of state law, or it must maintain the integrity of the general account and violate ERISA's fiduciary standards. The only apparent alternative is to treat the plan as having an undivided interest in all general account assets, with all of the general account assets managed for the exclusive purpose of the particular plan. This approach, of course, leads to absurdity. A company could never pay dividends to its owners out of general account assets, since to do so would be to divert the plan's undivided interest in the assets to a purpose not "solely in the interest" of a plan's participants.

Expanding ERISA's application in this way does more than create an analytical conundrum. It would have a far reaching, disruptive effect on insurance companies. First and foremost, the risk management activities that are central to the business of insurance companies would be impossible if ERISA were to apply to general account assets. One of the essential features of such risk management is the pooling or spreading of risks by the insurance company. ERISA would require the dissection of the general account so that specific assets would be held for

ERISA § 401(b)(2)(B), 29 U.S.C. § 1101(b)(2)(B), and a provision that exempts the purchase of an interest in a separate account from ERISA's prohibited transaction rules. ERISA § 408(b)(8), 29 U.S.C. § 1108(b)(8). The different treatment provided for this relatively small proportion of plan investments in separate account contracts demonstrates the congressional view that general account contracts, representing a very large proportion of plan investments, do not involve plan assets, and therefore do not require a special exemption from ERISA's prohibited transaction rules.

specific customers. The risks covered under contracts issued to such customers could not be pooled with the risks of other insurance company customers. The assets required by ERISA to be segregated for these customers could not be used to fund payments for risks realized by other customers.

For example, an insurance company's mortality risk under any particular annuity policy (*i.e.*, the risk that the particular group of annuitants will live longer than predicted) is spread among the risks assumed under all of the company's annuity policies. Over a sufficiently broad population, the overall mortality risk assumed by the company is spread, and the company's assets will be sufficient to satisfy all of its annuity obligations. But if, consistent with the Second Circuit's holding, assets are segregated and held exclusively for the benefit of particular plans, the advantage of risk spreading is substantially diminished. Participants in a plan with above-average longevity may find that their separate assets are insufficient to pay promised benefits, and further find that they may not look to assets segregated for other ERISA plans with a contrary experience.

Application of ERISA would also create conflicts with the comprehensive state efforts to ensure the solvency of insurance companies. For example, N.Y. Ins. Law § 1405 (a) limits the investment of "admitted" assets in the general account to no more than 20% in equity holdings. In the case of a fiduciary who is simply separately managing assets, the fiduciary might conclude that given his plan's characteristics and the available investment alternatives, it is desirable to hold more than 20% of the plan's assets in equity securities. If so, he may invest to accomplish that goal.[5] In contrast, the insurance com-

[5] Indeed, from 1985 through 1987 (the most recent years for which figures are available) single-employer defined benefit plans with more than 100 participants have consistently invested more than 20% of assets in equities. U.S. Dep't of Labor, Pension and Welfare Benefits Admin., *Trends in Pensions 1992*, at 475 (1992).

pany that has issued policies deemed to include plan assets faces an inherent limitation under the state's rules limiting the aggregate amount of general account assets that may be invested in equities. If many of these plans would benefit from a greater proportion of investment in equity holdings, how should the insurance company allocate the limited supply of equity vehicles mandated by the state's concern for maintaining company solvency? And how can this be done consistent with the state's rule that all policyholders, including non-ERISA policyholders, be treated equitably?

If the Court were to determine that general account assets are subject to all of ERISA's provisions, similar complications would result from the application of ERISA's prohibited transaction rules, ERISA § 406, 29 U.S.C. § 1106, to general account operations. For example, section 406(b)(2) prohibits a fiduciary from engaging in a transaction involving plan assets where the fiduciary represents a party with interests adverse to the plan. 29 U.S.C. § 1106(b)(2). If an insurance company must allocate general account assets among its various plan policyholders, how may it do so without inevitably violating this rule? The very act of allocation from unsegregated general account assets to segregated plan assets inherently involves a transaction in which the company represents different interests—the plan's interest and the general account's interest.

These examples merely underscore the point that Congress, which sought to avoid these incongruities specifically through ERISA's Insurance Savings Clause and broadly through the McCarran-Ferguson Act, did not intend the massive dislocation in insurance company operations and state regulation that would inevitably flow from the Second Circuit's mistaken interpretation of ERISA.

III. PURSUANT TO LEGAL PRINCIPLES CONSISTENTLY APPLIED UNDER ERISA, INSURANCE COMPANY GENERAL ACCOUNT ASSETS ARE NOT PLAN ASSETS.

A. ERISA Contains No Generally Applicable Definition Of Plan Assets. The Department Of Labor's General Definition Demonstrates That General Account Assets Are Not Plan Assets.

The Second Circuit's error in subjecting insurance company general account assets to ERISA is also amply demonstrated by an examination of the provisions of ERISA and the legal principles applied thereunder. The fiduciary rules of ERISA primarily regulate the conduct of fiduciaries with discretionary authority over the investment of employee benefit plan assets. Identification of plan assets is, therefore, central to the application of ERISA's fiduciary rules. Despite this, ERISA does not specifically describe nor in every instance delineate what assets constitute plan assets. In particular, ERISA does not comprehensively address the effect of indirect relationships, such as whether the acquisition of stock or other instruments or contracts by a plan in some fashion results in the assets of the issuing company being treated as plan assets.

ERISA's only provisions addressing plan assets status in the indirect investment setting are the specific rules in section 401(b) for shares issued by registered investment companies and guaranteed benefit policies issued by insurance companies. 29 U.S.C. § 1101(b). ERISA section 401(b)(2) provides that, where a plan purchases a "guaranteed benefit policy" issued by an insurance company, as defined in section 401(b)(2)(B), the plan's assets shall be the policy but shall not include the insurance company's underlying assets held in the general account. In LICONY's view, that section is dispositive of this case.

The language of section 401(b)(2) specifies only the treatment of a contract that is a guaranteed benefit pol-

icy; it provides no guidance with regard to plan assets determinations in situations not involving guaranteed benefit policies. Employee benefit plans may acquire and hold a variety of instruments issued by insurance companies, such as stock issued by a stock life insurance company or a security interest in assets held by an insurance company. These instruments are clearly not guaranteed benefit policies, yet neither do they result in the underlying assets of the insurance company being treated as assets of the plan owning the instrument. Section 401 (b)(2) should therefore be viewed as a safe harbor, rather than the exclusive means for determining the existence of plan assets.[6]

More broadly, the Department of Labor has recognized that ERISA contains no generally applicable statutory definition of plan assets. The Department moved to fill this void with a regulation setting forth a general definition which in terms does not specifially address insurance company general account assets. 29 C.F.R. § 2510.3-101 (1992). Given the Department's interpretation of section 401(b)(2), the lack of any specific mention of general account assets in the regulation is hardly surprising—in the Department's view, section 401(b)(2)

[6] Consistent with the language of ERISA section 401(b)(2) and its legislative history, the Department of Labor has interpreted ERISA section 401(b)(2) to mean that general account assets are not covered by ERISA. Because the Department of Labor is the agency charged with implementing and enforcing the fiduciary provisions of ERISA, its interpretations are entitled to the greatest possible deference by the Court. *Chevron U.S.A. Inc. v. Natural Resources Defense Council*, 467 U.S. 837, 844 (1984).

The court in *Mack Boring and Parts v. Meeker Sharkey Moffitt Actuarial Consultants*, 930 F.2d 267 (3d Cir. 1991), comprehensively analyzed both the language and the legislative history of ERISA section 401(b)(2), and both Petitioner and the American Council on Life Insurance as *amicus curiae* discuss these areas in great detail. LICONY agrees with the views expressed in those briefs. Consequently, we will not address the point.

completely disposes of the issue. 44 Fed. Reg. 50,363, 50,364 n.4 (August 28, 1979) ("[S]ection 401(b)(2) . . . mean[s] generally that assets held in an insurer's general account . . . are not plan assets . . . ."). If, however, the Court construes section 401(b)(2) differently, then the general definition of plan assets set forth in the regulation must still be considered to determine the status of general account assets. That general definition by itself provides complete insulation from plan assets treatment for insurance company general accounts.

B. Under The Generally Applicable Legal Principles Adopted By The Department Of Labor In Its Plan Asset Regulation, Insurance Company General Account Assets Are Not Plan Assets.

The Department of Labor's plan asset regulation begins with a broad principle:

> Generally, when a plan invests in another entity, the plan's assets include its investment, but do not, solely by reason of such investment, include any of the underlying assets of the entity.

29 C.F.R. § 2510.3-101(a)(2).[7]

The regulation then goes on to carve out a general exception for equity investments that are not publicly-offered securities. The purpose of this exception is to iden-

[7] The District Court extensively discussed Department of Labor Interpretive Bulletin 75-2 ("I.B. 75-2"), 29 C.F.R. § 2509.75-2 (1992), and other Department of Labor pronouncements regarding the plan asset determinaton. 722 F. Supp. at 1018-19. The Second Circuit briefly analyzed I.B. 75-2 and Department of Labor Advisory Opinions. 970 F.2d at 1144-45. The parties and *amici*, both below and in briefs regarding petitions for *certiorari*, have addressed the effect of the Department's plan asset regulation. *E.g.*, John Hancock Mutual Life Insurance Company Petition for a Writ of Certiorari at 14-15, and Appendix A-99; Brief of *Amicus Curiae* American Council of Life Insurance in Support of Petition for Writ of Certiorari at 7, 19-20; Brief of Plaintiff-Appellant Harris Trust and Savings Bank on Appeal before the Second Circuit at 11, 25, 26.

tify those situations in which a plan's investment in a supposedly separate entity is really nothing more than the retention of the managers of that entity to manage plan assets. If that is the effect of the investment, the regulation treats the assets of the entity in which the plan invests as plan assets. Preamble to Plan Asset Regulation, 51 Fed. Reg. 41,262 (November 13, 1986). To that end, the regulation states that plan assets treatment will result when: (1) the plan makes an equity (rather than a debt) investment in an entity; and (2) this investment is not covered by one of the further exceptions that protects against plan assets treatment, such as the exception for investments in an "operating company." 29 C.F.R. § 2510.3-101(3).

Applying this definition to general account contracts, it is apparent that such contracts do not give rise to plan assets treatment because the contracts are debt instruments rather than equity investments. But even if general account contracts are treated as equity investments, the issuing insurance company plainly falls within the regulation's exception for equity investments in an "operating company." Thus, whether such contracts are characterized as debt or equity under the regulation, the result is the same: the company's general account assets are not treated as plan assets.[8]

[8] We note that the Second Circuit erroneously concluded that the definition of plan assets provided in I.B. 75-2 would apply only in the case of the application of ERISA's prohibited transaction rules, and that a different standard would apply for determining the existence of plan assets for the purposes of applying ERISA's fiduciary duty rules. 970 F.2d at 1145. A logical reading of the statute eliminates this possibility. Fiduciary status regarding investment activities is determined specifically by reference to the existence of plan assets. ERISA § 3(21)(A), 29 U.S.C. § 1002 (21)(A). In the preamble to its plan assets regulation, the Department of Labor explained that the identification of plan assets is therefore the necessary first step in determining fiduciary status and the application of ERISA's fiduciary duty rules to such persons. 51 Fed. Reg. at 41,262. The Department continued:

1. *Because The Purchase Of A General Account Contract Establishes A Debtor/Creditor Relationship Under New York State Law, The Assets Of The General Account Of The Insurance Company Will Not Be Treated As Plan Assets.*

A necessary prerequisite for plan asset treatment under the Department's regulation is that the plan must make an investment in an "equity interest" in an entity. 29 C.F.R. § 2510.3-101(a)(2). The regulation defines "equity interest" as:

> any interest in an entity *other than an instrument that is treated as indebtedness under applicable local law* and which has no substantial equity features.

Id. § 2510.3-101(b)(1) (emphasis added). The rationale behind this provision is that, in the absence of an equity investment, the investing plan receives no interest in the underlying assets of the entity. This is the case, for example, with respect to a bank certificate of deposit. The plan's assets are the rights embodied in the debt instrument itself, not the debtor's underlying assets. 51 Fed. Reg. at 41,265-66.

The regulation looks to "applicable local law" to determine the character of the investment. 29 C.F.R. § 2510.3-101(b)(2). Under New York law, the purchase of an insurance contract the proceeds from which are held in the insurance company's general account establishes a debtor/creditor relationship. *Associates in Adolescent Psychiatry v. Home Life Ins. Co.*, 729 F. Supp. 1162, 1186 (N.D. Ill. 1989) (applying New York

> Moreover, the fiduciary responsibility provisions of ERISA include prohibited transaction provisions which restrict the manner in which fiduciaries may deal with the assets of a plan.

Id. See Massachusetts Mut. Life Ins. Co. v. Russell, 473 U.S. 134, 141 n.8 (1985) (the fiduciary self-dealing prohibitions in ERISA section 406(b) establish a duty of loyalty for plan fiduciaries). The Second Circuit's conclusion in this regard should, therefore, be rejected.

insurance law), *aff'd on other grounds*, 941 F.2d 561 (7th Cir. 1991), *cert. denied*, 112 S. Ct. 1182 (1992); *Fidelity and Casualty Co. of New York v. Metropolitan Life Ins. Co.*, 42 Misc. 2d 616, 248 N.Y.S.2d 559, 565 (1963); *Clifford v. Metropolitan Life Ins. Co.*, 264 A.D. 168, 34 N.Y.S.2d 693, 695 (1942); *Bogardus v. New York Life Ins. Co.*, 4 N.E. 522 (1886); *People v. Security Life Ins. & Annuity Co.*, 78 N.Y. 114 (1879); G.J. Couch, *Couch on Insurance 2d* § 23.11 (rev. ed. 1984.)

In addition, the regulation requires that debt investment must have "no substantial equity features." Participation in general account experience, which is a key feature of most general account contracts used for pension plan funding, does not constitute a "substantial equity feature." *Associates in Adolescent Psychiatry*, 729 F. Supp. at 1186-88. There are two reasons why this is so. An equity investment is one that is dependent upon the discretion of management rather than being a fixed contractual commitment. In many cases, the participation element of general account contracts is discretionary, but the discretionary feature is insubstantial compared to the nondiscretionary features of the contract. *Id.* at 1188 (equity feature that is merely incidental to the primary fixed obligation does not cause plan asset treatment under the regulation). In other cases, the participation element of the contract represents a contractual commitment to credit interest in accordance with a fixed formula or procedure that does not permit management discretion. *Id.* at 1186. The insurer's contractual obligation to pay interest under this fixed formula or procedure demonstrates that the underlying obligation is a debt rather than an equity interest. *See e.g.*, Rev. Rul. 83-51, 1983-1 C.B. 48 (amounts paid pursuant to formula are ordinarily considered to be interest on debt where a definitely ascertainable sum is paid for the use of borrowed money).

A participating general account contract will, therefore, be treated under the regulation as indebtedness with no substantial equity features and the assets of the general account will not be plan assets subject to ERISA.

2. *Even If The Purchase Of A General Account Contract Were Treated As An Equity Investment, Such Purchase Would Constitute An Investment In An Operating Company And Therefore Would Not Cause Plan Asset Treatment.*

Even where the plan investment in an entity is treated as an "equity interest," that characterization will not subject the entity's assets to treatment as plan assets if the entity falls within the regulation's exception for an "operating company." 29 C.F.R. § 2510.3-101(a)(2)(i). An operating company is defined as:

> an entity that is primarily engaged, directly or through a majority owned subsidiary or subsidaries, in the production or sale of a product or service other than the investment of capital.

Id. § 2510.3-101(c). This exception was included in the original proposed regulation, 44 Fed. Reg. 50,363, 50,366-67 (August 28, 1979), and was a constant during the seven year regulatory process leading to the issuance of the final plan assets regulation. The Department's intention in including this exception was to distinguish vehicles created merely for the indirect provision of investment management services from those enterprises engaged in an active trade or business. 51 Fed. Reg. at 41,270. As explained in connection with a reproposed version of the operating company exception:

> Where an enterprise is not designed to function as the investment intermediary, an investment in the enterprise should not be deemed to be the equivalent of a delegation of investment management authority. This would be the case, for example, with an investment in an "operating" company.

45 Fed. Reg. 38,084, 38,085 (June 6, 1980). Indeed, the final regulation recognizes that some entities may nevertheless possess some investment management characteristics and still qualify as operating companies. 51 Fed. Reg. at 41,271.[9]

This Court has repeatedly recognized that the principle business of insurance companies is the spreading and management of various types of risk. *Union Labor Life Ins. Co. v. Pireno*, 458 U.S. 119, 127-28 (1982); *Group Life & Health Ins. Co. v. Royal Drug Co.*, 440 U.S. 205, 211 (1979). In undertaking this business, insurance companies clearly function as operating companies within the contemplation of the regulation.

In order to provide these risk management services and products, the insurance company engages in a broad variety of business-related activities, including hiring employees; paying taxes; owning, leasing and managing office buildings; purchasing furniture and office equipment; providing administrative services; and paying dividends to owners. All of these activities are carried on through the

[9] *See* 29 C.F.R. § 2510.3-101(d) (venture capital funds that qualify for treatment as "venture capital operating companies"); *id.* § 2510.3-101(e) (real estate investment vehicles that qualify for treatment as "real estate operating companies"). The entities covered by these special operating company definitions derive their operating company status solely from the types of investments they make and the management activities undertaken as the result of those investments. Thus, for example, a venture capital operating company must invest a specified portion of its assets in subsidiary portfolio companies as to which it possesses management rights. *Id.* § 2510.3-101(d)(3). Similarly, a real estate operating company must invest a specified percentage of its assets in real estate related investments that are actively managed. *Id.* § 2510.3-101(e)(1). Except for the fact of these regulatory exceptions, these entities in most respects are indistinguishable from insurance company separate accounts and the other types of pooled investment vehicles that the Department has concluded will in all cases hold plan assets. *See id.* § 2510.3-101(h)(1).

general account, which is the operating account of the insurance company.[10]

Insurance companies therefore are engaged in the operation of a business, and as such qualify as operating companies under the Plan Asset regulation. In doing so, it is clear that insurance companies do not exist solely as a surrogate for the delegation of plan investment management authority. Indeed, it would be incomprehensible to exclude insurance companies from operating company status when the Department has recognized this status in entities with far fewer operating company characteristics.

Accordingly, to the extent that a plan purchasing a general account contract is deemed to have made an equity investment in an insurance company, the insurance company must be viewed as an operating company, and the assets held in its general account insulated from plan asset treatment under the terms of the Department's regulation.

[10] Respondent has criticized petitioner for holding assets such as its Home Office building in the general account, and has intimated that such holdings could involve prohibited transactions under ERISA section 406, 29 U.S.C. § 1106. *See* John Hancock Mutual Life Insurance Company Petition for Certiorari at A-31-32. Aside from demonstrating the anomalous consequences of applying ERISA's fiduciary duty rules to the insurance company general account, Respondent's position demonstrates a complete lack of understanding of the function of the general account. The general account is not a pooled investment fund held for the benefit of all policyholders. Rather, it is comprised of all assets held by the insurance company in the operation of its general business.

CONCLUSION

The decision of the court of appeals, insofar as it reversed the judgment of the district court dismissing the action, should be reversed.

Respectfully submitted,

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